



Does Quality of Financial Statement Affected by Internal Control System and Internal Audit?

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ABSTRACT

The purpose of this study to examine and analyze the influence internal control systems and internal audit to financial statement quality of local government. Usefulness of research as input for local government to improve implementation internal control, effectiveness of the internal audit function and improve quality of financial reports. Data conducted by taking 66 local government unit tool of the 15 districts and city in Indonesia. Analysis data study using path analysis. The conclusion is internal control system and internal audit partially and simultaneously have positive effect on the quality of financial statements.

Keywords: Internal Control Systems, Internal Audit Function, Financial Statement Quality

JEL Classifications: G2, M4

1. INTRODUCTION

Good governance is an important issue in the management of public administration today. Good governance practices can improve the climate of openness, participation and accountability in accordance with the basic principles of good governance in the public sector. The challenge to realize this goal is very heavy, because the behavior of businesses and public services by the government during the long period of time has been tainted by corruption, collusion, and nepotism. This cause of Indonesia as one of the country are still high levels of corruption. Institute of Transparency International released corruption perception index for 2015. The report mention there are 168 countries surveyed, and Indonesia was ranked 88. Corruption perception index for 2015 can be seen in Table 1.

Sri Mulyani as Republic Indonesia finance minister said that despite unfavorable fiscal situation need to manage finances well become very urgent. According to her, financial managers not only pursue an unqualified opinion, but must be accompanied by indicators of accountable management and uncorrupted. Financial statements expected more qualified that we were able ultimately get public trust through the good financial statements local and central government (<http://economy.okezone.com>).

Main purpose of financial reporting is provide high quality financial statements relating to information about economic entities, the financial condition of the real beneficial for decision (FASB, 1999; IASB, 2008). Provide information of high quality financial reporting is very important because the quality of financial reporting will give positive effect on capital providers and other stakeholders in making investment, credit, allocation of existing resources and the decision to increase the overall efficiency of the market. (IASB, 2008). Many people will rely on the information in the financial statements published by the local government as a basis for decision making. (Swardjono, 2005). Empirical studies examining the influence of previous US GAAP and IFRS to quality of financial report shows positive, not significant, and negative influence (Barth et al., 2008; Van Der Meulen et al., 2007; Bartov et al., 2005). Dien (2014) concluded that there is a positive influence quality of internal audit on financial statements.

The same thing was said by the President Joko Widodo who asked all the officials of ministries and state institutions not to be easily satisfied with status unqualified from Indonesia audit board. Unqualified opinion is no guarantee of an institution clean. State agencies should enhance financial management and reporting system after unqualified opinion. President said that there are still

many things that can be enhanced from now existing financial reporting system (<http://www.antaraneews.com>).

Indonesian supreme audit (BPK) has audited financial statements as many as 533 local government financial statement of 542 local authorities required to prepare financial statements. Figure 1 shows the examination results summary financial statements opinion of local government in 2015. There are 312 local governments received unqualified opinion (58%). Qualified opinion given to 187 local government or 35%. Disclaimer opinion given to 30 local Governments (6%) and adverse opinion to 4 local Government (1%).

Chairman of the supreme audit agency (BPK) Harry Azhar Aziz assessing that financial statements management local government have not been as good as the ministry and institution financial statements management. Therefore, the central government should be encouraging and fostering local government in managing their financial statements for the future to be better (<http://www.antaraneews.com>). Composition Internal Internal System weaknesses local government can be seen in Figure 2.

Based on the results of Indonesia audit board on Local Government Finance Report (LKPD) city and district can be said that the factors influence quality of financial reporting is: (1) Resentation of financial statements follow conformity government accounting standards and follow up on the findings of the supreme audit board (BPK) and a commitment to monitor implementation of internal control system; (2) control Inter al mainly controls to improve the quality of financial statement. From description above, the purpose of this research is to examine and analyze the influence internal control systems and internal audit to financial statement quality of local government.

2. LITERATURE REVIEW

2.1. Internal Control System

Definition of internal control proposed by Konrath (2002), quoting from the American Institute of Certified Public Accountants Professional Standards, defines internal control as follows: “The process effected by an entity’s board of directors, management, and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) Perating control-relating to the effective and efficient use of the entity’s resources; (b) financial reporting controls-relating to the preparation of reliable published financial statements; and (c) compliance controls-relating to the entity’s compliance with applicable laws and regulations.”

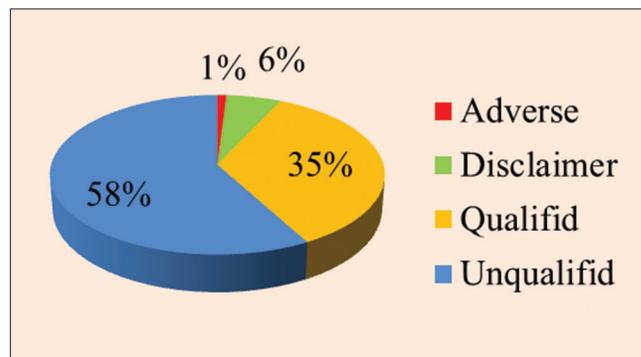
Committee of Sponsoring Organizations of the Treadway Commission (COSO, 2013) defines internal control is “a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.” Boynton et al. (2006) says: Control the safeguarding of assets against unauthorized acquisition, use, and, disposition. Internal control comprises the plan of organization and all of the

Table 1: Ranking and score corruption perception index 2015

Regional ranking	Global ranking	Country	Score
2	8	Singapore	85
9	54	Malaysia	50
11	76	Thailand	38
15	88	Indonesia	36
16	95	Philipines	35
17	112	Vietnam	31
24	147	Myanmar	22

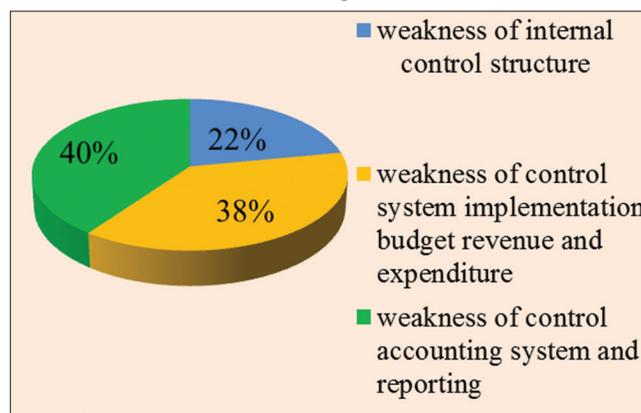
Source: Transparency international

Figure 1: Udit board opinion for the year 2015



Source: Indonesian Supreme Audit, 2016

Figure 2: Composition Internal System Weaknesses local Government Financial Reports 2015



Source: Indonesian Supreme Audit, 2016

coordinate and methods measures adopted within a business to safeguarded its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. (Sawyer, 2003; Undang-Undang No 60/2008).

To achieve internal control objectives, that is (a) the reliability of financial statements, (b) effectiveness and efficiency of operations and (c) compliance with applicable laws and regulations management must apply the components of internal control in every operating activities.

Based on the above, the components of internal control in this study refers to components and sub-components as described above, namely: (1) Control environment, (2) risk assessment,

(3) control activities, (4) information and communication systems, and (5) monitoring (COSO, 2013).

2.2. Internal Audit

Internal audit is an one of organization function in charge to test and evaluate the activities of the organization. "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance process." (IIA, 1999).

Furthermore Sawyers (2003) defines the internal audit as: "Internal auditing is a systematic objective appraisal by internal auditors of the diverse operation and controls within an organization to determine whether: (1) Financial and operating information is accurate and reliable; (2) risk to the enterprise are identified and minimized; (3) external regulations and acceptable internal policies and procedure are followed; (4) satisfactory operating criteria are met; (5) resources are used efficiently and economically; and (6) the organization's objectives are effectively achieved-all for the purpose of assisting members of the organization in the effective discharge of their responsibilities." Internal Audit helps the organization to achieve its objectives through a systematic and orderly approach to evaluate and improve the effectiveness of risk, control and governance processes of the organization. (Boynton et al., 2006).

According to Abdul (2004), there are three aspects of the independence of an auditor is as follows: (1) Independence in fact the auditor must have a high honesty; (2) independence in appearance are the views of others against themselves auditor in connection with the audit. The auditor should keep his position in a way that others will believe the attitude of independence and objectivity; and (3) independence in competence which are closely related to the competence or the ability of auditors to carry out and complete the task.

Pickett (2003), illustrates the independence of the internal auditor as follows: "We have to balance two considerations in deciding on any proposed move away from accountancy: (1) Need to secure a level of independence from the finance function that is commensurate with the increasingly high profile of the internal audit function, (2) need to secure full commitment of the Director of Finance to support the continuing presence the internal auditing function."

2.3. Quality of Financial Statements

Quality of the financial statements in the public sector, especially in regions according Mardiasmo (2009) is a financial statement that is able to present financial information relevant and reliable. Wood and Horner (2010) defines the quality of financial statements as well as reports present fairly the state of entities and activities and provide useful information to users of financial statements. Brookson (2009) define the quality of the financial statements as reported in accordance accounting standards of financial reporting which shows the financial position and results of operations of an

entity at the end of the period. The quality of financial reporting is generate useful information for their use: Information which the characteristics of quality information or financial information quality characteristics (IPSAS, 2010; Jonas and Blanchet, 2000).

The quality or characteristics of useful financial information should be considered in order to increase the added value for the entity (PP No. 71/2010). Characteristics of quality information according to Bodnar and Hopwood (2010). Include the following: (1) Relevance (relevant), (2) reliable (reliable), (3), complete, (4), timely, (5) Understandable, (6) verifiable (to be verified). Similar opinion presented by O'Briens and Maracas (2010) that the quality of accounting information can be described in three dimensions: Relevance, timelines, accuracy. Otherwise said by Madison (2010) that quality of financial statements must be understandable, relevant, reliable and comparable. In opinion of Van Beest et al. (2009); International Public Sector Accounting Standards (IPSAS, 2010) that the quality of the financial statements can be viewed by: Relevance, Faithful representation, understandability, comparability, timelines. Furthermore, according IPSAS (2010) within a conceptual framework that Faithful representation, neutrality, and completeness identified as a component of reliability.

Users of financial statements using financial statements to take economic decisions and rely on financial statements which have been audited to obtain a guarantee of reliability of financial statements that are used to support decisions in lending. (Arens et al., 2014; Boynton et al., 2006). Similarly, Cohen and Kaimanakis (2011) state audit opinion provides assurance that the financial statements have been prepared in accordance with accounting standards, and that the financial position, results of operations, and the amount of surplus or deficit is fairly stated on the organization being audited. In addition the audit report is also important as a deterrent to the emergence of low-quality information.

3. THEORITICAL FRAMEWORK

Generally internal control system has five components: (1) control environment (2) risk assessment, (3) control activity, (4) information and communication, and (5) monitoring (COSO, 2013). Some studies suggest that there is significant influence internal control system of the quality of accounting information. Research Doyle et al. (2007) found that generally weakness in company's internal control system over financial reporting will weaken the quality of accounting. According with the internal audit function should assist effective internal organization control by evaluating the adequacy, efficiency, and effectiveness of these controls, and to encourage continuous improvement of internal control (IIA, 2001).

According to Cheung and Qiang (2002) that the internal audit function will enhance good governance. Therefore, it is proper internal oversight function more used and implemented in synergy for the achievement of good governance in the public sector to encourage transparency, accountability in state finance management. The results of study by Doyle et al. (2007) showed that the weakness of internal control has an effect on the low

quality of accruals add more the evidences of the existence of an effect internal control on the quality of an accounting information. Research conducted by Dewi (2014) suggests that the dimensions and indicators within apparatus government competence and internal control can be used to measure the quality of financial statements. Altamuro and Beatty (2010) said: Improvements of monitoring and reporting on internal control to improve the quality of financial reporting on the banking industry.

Furthermore, to achieve effective management of state finances, efficient, transparent, and accountable, institution leaders, governors and regents/mayors have to do control over implementation of the activities government based on government internal control system. (Undang-Undang No.60/2008).

Research by Angus and Mohammed (2011) states that there is a weak correlation between internal audit function and financial statements in Saudi Arabia. Another study presented by Angus et al. (2011) that internal audit effective to detect fraud and fraudulent activity. In another study internal audit function can improve the control environment will be reflected in the quality of financial reporting to reduce reporting fraud (Gordon and Smith, 1992) and block deviation financial reporting (Schneider and Wilner, 1990). From some above research can be said that implementation of audit sector public conducted by local government inspectorat level will produce higher quality of financial statements.

From the discussion above, Conceptual research framework of study can be described as in Figure 3.

4. METHODOLOGY

Research methods used explanatory research survey that describes the relationship between variables in the population studied, to explain the characteristics of the problems or phenomena encountered.

Type of research is verification which aims to determine the relationship between variables through a hypothesis testing. The time period is cross sectional (Sekaran, 2006). This research was conducted by taking 66 local government unit tool of the 15 districts and city North Sulawesi Province of Indonesia. Analysis data study using path analysis.

Source of data to be used in this study was type primary data. Data test data using validity and reliability test. Then product moment correlation value compared with t-table. If t-value is bigger than

t-table means the product moment correlation for each item statement is valid. When $t\text{-value} \geq t\text{-table}$ at $\alpha = 0:05$ means the data significant (valid) and fit in testing the research hypothesis. Conversely if $t\text{-value} \leq t\text{-table}$ meaning that data is not significant (not valid) and can not be included in the research hypothesis testing. The validity of the test results can be seen in Table 2.

5. RESULTS AND DISCUSSION

Results of analysis data obtain direct effect and indirect effect of variable X1 (internal control system) and X2 (internal audit) partially and simultan to variable Y (the quality of financial statements) variable implementation of the internal control system (X1) to the variable quality of the financial statements (Y) directly influence 15.52%. The magnitude of the indirect effect of variable implementation internal control system (X1) through a variable internal audit (X2) on quality of financial statements (Y) is 11.60%. Total direct and indirect effects of the internal control system (X1) through a variable internal audit (X2) to quality of the financial statement (Y) is 27.12%. Results testing of first hypothesis means that the hypothesis Ho is rejected and Ha accepted. The direct effect of variable internal audit (X2) to the variable quality of the financial statements (Y) 47.55%.

The second hypothesis will be tested in this study are: Implementation of internal control system and internal audit together affect the quality of financial reporting. Accepted this hypothesis implies that independent variable implementation internal control system (X1) and internal audit (X2) simultaneously affect the quality of financial reporting with coefficient of multiple determination 74.67%. There are significant external variables to variable Y with a value of 25.33%.

The results showed that the implementation of the system of internal control and internal audit have a positive effect on the quality of financial statements. This study produced a model in the form of a causal relationship between variables path diagram; government internal control systems, internal audit to the quality of local government financial statements. Specifications causal relationship model and the identification of variables are designed based on the concepts and theories that are relevant as well as referring to the frame of logical construct.

6. CONCLUSION AND RECOMENDATION

Based on the analysis and discussion of the research results can be concluded as follows: The internal control system and internal audit partially have positive effect on the quality of financial statements. Internal control system and internal audit simultaneously influence on the quality of financial statements.

Advised to local authorities more serious improving the implementation of internal audit suggested to local governments is more serious in improving the implementation of internal audit. If there are unresolved audit findings must be completed in accordance with resolution mechanism specified audit recommendations. If there are unresolved audit findings must be completed in accordance with resolution mechanism specified

Figure 3: Conceptual research framework

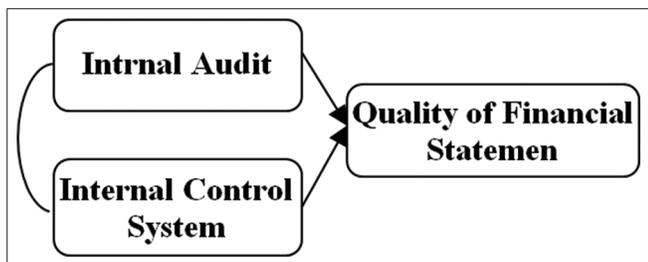


Table 2: Validity test results

Dimension	Scale mean if item deleted	Scale variance if item deleted	Corrected item-total correlation	Squared multiple correlation	Cronbach's alpha if item deleted
Control environment	1435.45	39989.41	0.607	0.444	0.815
Risk assessment	1441.35	40461.50	0.767	0.861	0.777
Control activity	1420.70	41152.22	0.794	0.807	0.775
Information and communication	1426.30	38388.32	0.443	0.343	0.892
Monitoring	1423.80	40481.32	0.790	0.762	0.773
Independence	1339.50	33035.52	0.855	0.800	0.673
Professional capabilities	1301.10	37243.14	0.629	0.740	0.742
Scope of assignment	1308.30	40432.11	0.348	0.375	0.820
Implementation	1421.15	33697.60	0.575	0.604	0.754
Management of internal audit section	1324.35	32525.50	0.552	0.590	0.767
Relevan	1426.30	38388.32	0.443	0.343	0.892
Reliable	1009.85	14439.29	0.515	0.375	0.009
Timelines	1301.10	37243.14	0.629	0.740	0.742
Comparability	1441.35	40461.50	0.767	0.861	0.777

audit recommendations. Practise accounting functions from analysis to reporting financial transactions more transparent and accountable if performed by qualified human resources, which has competent and have background appropriate educational.

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